

# ANALYSIS OF ORIGINAL BILL

## Franchise Tax Board

Author: Wyman Analyst: Darrine Distefano Bill Number: AB 1862  
Related Bills: See Legislative History Telephone: 845-6458 Introduced Date: 01/31/2002  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Credit for Employee Benefits Paid to Employees Who Are On Active Duty With National Guard or Military Reserve On or After 9/11/2001

### SUMMARY

This bill would allow a 100% credit for wages paid to a qualified employee who is on active duty as a result of Operation Enduring Freedom or any successor military action.

This bill also would make changes to the Government Code and Military and Veterans Code regarding employees ordered to active duty as a result of Operation Enduring Freedom. These changes do not affect the department and are not discussed in this analysis.

### PURPOSE OF THE BILL

The intent of this bill is to encourage private employers, that have employees called to active duty, to offset in pay the difference between their employee's military pay and employee's wages.

### EFFECTIVE/OPERATIVE DATE

This bill is an urgency measure. It is effective immediately upon enactment and operative for taxable years beginning on or after January 1, 2002.

### POSITION

Pending.

### ANALYSIS

#### FEDERAL/STATE LAW

Under federal and state laws, compensation received by a member of the armed forces is subject to income tax unless specifically excluded. Compensation received for any month while serving in a combat zone or qualified hazardous duty area is excludable. Other qualified military benefits that are excludable from income include:

- benefits paid by the Veterans Administration, such as disability compensation, pensions, educational assistance, etc.;
- certain medical benefits, military disability benefits, and various travel allowances; and
- dislocation allowances, temporary lodging allowances, and move-in housing allowances provided for a permanent change of station.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
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<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

Gerald H. Goldberg

2/20/02

Under current state and federal laws, a member of the armed forces of any country and the uniformed services of the United States may exclude from gross income amounts received as a pension, annuity, or similar allowance for personal injury or sickness resulting from active service.

### THIS BILL

This bill would allow a 100% credit for the amount of benefits paid by an employer to a qualified employee.

This bill would define “qualified employee” as any member of the California National Guard or United States military reserve organization who is called to active duty on or after September 11, 2001, as a result of Operation Enduring Freedom or any successor military action.

This bill would define “benefits” as the difference between the amount of military pay and allowances while on active duty and the amount that would have been received by the employee, including any raises that would have been granted.

Any excess credit could be carried over until exhausted.

### IMPLEMENTATION CONSIDERATIONS

This bill does not limit the number of years the credit may be carried over to future years. The department would be required to retain the carryover on the tax forms indefinitely because unlimited credit carryover is allowed. Recent credits have been enacted with a limitation on the number of years for carryovers since experience shows credits typically are exhausted within eight years of being earned.

The author may wish to further define military pay and allowances. Certain benefits are excluded from gross income but appear on the employee’s military paycheck. It may be difficult for employers to know what these items are in order to determine how much should be paid to make up the difference. Also, an employer may provide health, dental, retirement, or cafeteria plan payments for their employee. It is not clear if the employer would have to consider these types of payments to calculate the differences in pay. While it appears the bill’s intent is to make up the difference in salary regardless of what items are taxable, further clarification will be helpful for the employer and the Franchise Tax Board.

### **LEGISLATIVE HISTORY**

Prior law (Stats. 1943, Ch. 147) allowed a deduction from gross income for all salaries, wages, bonuses, allowances, and other compensation received for service as a member of the Armed Forces for taxable years 1943 through 1948 (World War II). Ch. 12, Stats. 1952, reinstated the World War II exclusion but limited it to \$1,000 per year.

In 1971, another law (Stats. 1971, Ch. 1, Extraordinary Session) further limited the exclusion to compensation (other than pensions and retirement pay) received for service on extended active duty. For taxable years beginning on or after January 1, 1973, Stats. 1972, Ch. 1359, added an annual \$1,000 exclusion from gross income for pensions and retirement pay as well as for compensation for other than extended active duty. However, this exclusion was limited to taxpayers with adjusted gross income of \$17,000 or less.

AB 66 (Stats. 1985, Ch. 1461) increased the phase-out range to \$27,000 for taxable years beginning on or after January 1, 1985. AB 4419 (Stats. 1986, Ch. 779) excluded from gross income up to \$500 per month received for active duty service pursuant to a Governor-declared emergency. AB 53 (Stats. 1987, Ch. 1138) repealed each of these exclusions and established a tax credit, not to exceed \$40 in any taxable year, based on various types of military income. The credit was repealed by its own terms effective January 1, 1992.

## OTHER STATES' INFORMATION

Research of *New York, Illinois, Michigan, Minnesota* and *Massachusetts* found that these states do not tax their residents for any military pay received during the taxable year.

Since this bill is being introduced due to the events of September 11, 2001, other states may also introduce similar legislation to help taxpayers who are called to active duty.

## FISCAL IMPACT

Once the implementation concerns are resolved, this bill would not significantly impact the department's costs.

## ECONOMIC IMPACT

### Revenue Estimate

This bill would result in revenue losses as shown in the following table:

Revenue Impact of AB1862 For Taxable Years Beginning On Or After 1/1/2002 Assumed Fast Track Enactment Fiscal Year Impact (In Millions)		
2001-2	2002-3	2003-4
-\$10	-\$45	-\$25

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

### Revenue Discussion

The impact of this bill would depend upon: (1) the number of businesses that incur qualifying expenses for benefits paid to employees who are called to active military duty and are on active duty during the taxable year and (2) the average credit applied against tax liabilities.

This estimate assumes that the author's intent is that a "qualified employee" be a resident of or employed in California.

Based on the actual number of reservists and National Guard called to active duty to date in California, it is estimated that approximately 6,500 personnel years of reservists and National Guard would be called and used for active duty in 2002. For 2003, it is assumed that one fourth, as many would be called for active duty. For 2004 and thereafter, it is assumed that a minimal number of reservist and National Guard would be called as a result of Operation Enduring Freedom or any successor military action. If additional personnel are called to active duty in 2002 or thereafter, the revenue impact could be much greater.

#### Concerns:

- According to information from various sources, it is estimated that the number of reservist and National Guard called to active duty would decline significantly over time. This would place fiscal year filers at some disadvantage. Many fiscal year filers would incur qualifying expenses at a time when it is estimated that the greatest number of reservist and national guard would be called to active duty and would not be entitled to the credit, since their fiscal year began prior to 1/1/2002.
- If the author's intent is to allow qualifying expenses incurred on or after 1/1/2002 (rather than tax years beginning on or after 1/1/2002), and assuming fast track legislation, then the revenue loss would be as follows:

Revenue Impact of AB1862 For Expenses Incurred After 1/1/2002 Assumed Fast Track Enactment Fiscal Year Impact (In Millions)		
2001-2	2002-3	2003-4
-\$10	-\$55	-\$30

Note: If legislation is not fast tracked then this scenario could become a gift of public funds.

## **ARGUMENTS/POLICY CONCERNS**

Credits generally are provided as a percentage of amounts paid or incurred. This bill would allow a 100% credit, which is unprecedented.

This bill does not contain a sunset date. Generally, credits contain a sunset date that ensures the Legislature will review its effectiveness.

Many employees have been called to active duty to assist with clean up at the sites of the terrorist attacks and to provide security at the airports or other high security risks sites. These employees were called to duty for Homeland Security and not "Operation Enduring Freedom." This bill will not benefit an employer who made payments to employees called to active duty for these assignments.

This bill would not benefit self-employed taxpayers who are also called to active duty. A taxpayer who is self-employed will not be able to take a credit on the benefits paid as defined in the bill. Thus, this bill would provide differing treatment based solely on classification.

Conflicting tax policies come into play whenever a credit is provided for an item that is already deductible as a business expense. Providing both a credit and allowing the full amount to be deducted would have the effect of providing a double benefit for that item. On the other hand, making an adjustment to deny the deduction in order to eliminate the double benefit creates a difference between state and federal taxable income, which is contrary to the state's general federal conformity policy.

This credit would not be limited to benefits paid to employees that are employed in California. As a result, the bill would allow a 100% credit to benefits paid by an employer to an employee anywhere. The author may wish to limit the credit to benefits paid to employees employed in CA.

## **LEGISLATIVE STAFF CONTACT**

Darrine Distefano  
Franchise Tax Board  
845-6458

Brian Putler  
Franchise Tax Board  
845-6333